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C O N F I D E N T I A L SECTION 01 OF 02 BAGHDAD 003453

SIPDIS

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SUBJECT: MINISTER OF FINANCE ON GOI 2006 BUDGET AND 2005 SUPPLEMENTAL

Classified By: Deputy Chief of Mission David M. Satterfield for reasons 1.4 (b) and (d).

1. (C) Summary. On August 21, Finance Minister Allawi told us how he plans to structure the GOI 2006 budget and address food and fuel price subsidies within that budget. Allawi has withdrawn his request for a 2005 supplemental, and will use emergency funding to meet 2005 spending needs. He plans to discuss these issues with the IMF and with us at next month's mini-JCRED meeting in Washington. End summary.

2. (C) Mission Iraq's Treasury Attache, A/ECON Counselor, and IRMO/Financial and Fiscal Affairs Advisor met with Finance Minister Allawi and Chief of Staff Al Kateeb on August 21 to discuss the Joint US/GOI Financial and Fiscal Task Force, the JCRED to be hosted by the U.S. Treasury in Washington, DC on September 22, the 2005 GOI supplemental budget, and the 2006 GOI budget. The Treasury Attache told Allawi of Washington impressions that there seems to be flexibility in the IMF's position on subsidy reform. The Attache also said the Fund plans to discuss certain aspects of the Article IV consultations at the next meeting in Amman, as well as the 2006 budget.

No 2005 Supplemental

3. (C) Regarding the 2005 supplemental, Allawi said he has rejected the idea of putting it forward without subsidy reforms. The government does not have the will or the desire to undertake such reforms, he said. Consequently, it is better to focus on the '06 budget than the '05 supplemental. The Ministry of Finance will manage the expected deficit through increased cash flow from higher oil prices, increased exports through the northern pipeline, and reduced capital spending. He is prepared to meet the government's funding requirements for the remainder of '05 by allowing ministries to reallocate funds within their budgets, by reallocating funds among ministries, and by drawing from a \$1 billion emergency fund. Acknowledging that the Ministry of Interior will need additional funding for salaries, Allawi said he is willing to provide the necessary funding.

Preparing the 2006 Budget

4. (C) Allawi said the 2006 budget process has begun. A draft should be ready for the IMF meeting, but the definitive 2006 budget will not be ready by the October 10 deadline for submission to the TNA. He stressed that the budget process needs to be top down rather than bottom up and that the budget should be a strategic document. The oil sector will receive additional funding in 2006 since it is the single largest source of GOI revenue. The government needs to focus on revenue generation and subsidy reform. He will propose a plan to repeal fuel and other subsidies concomitant with the establishment of social welfare safety net. Another measure will be the direct distribution of \$1 billion to the provinces based on population in lieu of mandatory revenue sharing. As part of a second phase to create regional development banks, the GOI will invest \$500 million in the banks over three years. The Ministry of Finance will propose that the 2006 capital budget of all ministries except the oil and the security ministries be augmented by 15 percent relative to 2005. Since Allawi realizes that USG funding of the security forces will decrease in 2006 and that the GOI will have to provide the required funding, funding for the Ministry of Oil will rise substantially. Allawi expects most ministries will continue to underspend their capital budgets in 2005, thus allowing the unspent funds to the tune of a billion dollars to be transferred to the Ministry of Oil in 2006.

A Long-Term Strategy for the 2006 Budget

5. (C) Allawi said he wants to reduce government subsidies beginning with the 2006 budget. He plans to introduce subsidy-spending limits of 85 percent of 2005 actual spending, the goal being 75 percent of actual 2005 spending. This reduction is intended to be the first of several phases within a four-year plan. He suggested that the GOI will establish a safety net for the disadvantaged during the period. Expected investment in the oil sector will lead to the export of 1.8 million b/d beginning in 2006 and 2.2

million b/d by the end of 2006. Allawi said he wants to promote foreign investment in the sector to increase production from existing fields and new fields. The plan to do this envisions technical assistance and training, as well as capital.

16. (C) Allawi shared an informal draft strategy paper on the 2006 budget with Mission officials (emailed to Treasury and NEA/I/ECON). The strategy would raise or impose new taxes on mobile phones, automobiles, firearms, as well as increase customs duties from 5 percent to 10 percent. Allawi said he intends to improve the capability of the Ministry's personnel to collect taxes, fees and duties. Its capacity-building program foresees hiring of foreign nationals to fill key posts within the ministries, mentoring of Iraqi personnel, and creation of an academy to provide formal management training.

17. (C) Allawi said he is committed to the GOI's honoring its international agreements. He is prepared to begin debt negotiations with the UAE, Kuwait and Saudi Arabia. He prefers to negotiate with the Saudis after he has completed the arrangements with the UAE and Kuwait.

18. (C) Allawi also said he believes "the budget is a major tool to meet the economic, financial, and social targets of the government." He intends to use it to pursue:

- real GDP growth of 10 percent,
- unemployment of 10 percent of the active labor force by 2010,
- inflation not to exceed 10 percent,
- reform and restructuring of state-owned enterprises, and
- modernization of GOI administrative processes and procedures.

19. (C) Mission officials gave Allawi and his chief of staff a copy of a draft 2006 budget predicated on the IMF Article IV consultations for their markup. They asked that the Ministry share with the Embassy what it will pull together so that it can in turn share this product with U.S. Treasury for follow-up with IMF.

110. (C) Allawi agreed to participate in Embassy's proposed US/GOI joint task force on budget and fiscal issues. He made it a point, however, to note that the task force will not be a joint policy-making mechanism.
Khalilzad